Operating Costs and Expenses

	Years Ended December 31,		
	1998	1997	1996
		(Dollars in Millions)	
Cost of services and sales	$ 5,485	$ 5,028	$ 4,884
Selling, general and administrative	2,184	2,165	2,140
Depreciation and amortization	2,591	2,605	2,642
Special charges	171	--	--
Total operating costs and expenses	$ 10,431	$ 9,798	$ 9,666

Cost of services and sales

The 1998 and 1997 increases were primarily driven by growth in inventory management and purchasing services to third-party customers and higher volumes. The 1998 increase is also due to the recording of pension settlement gains in 1997, which resulted from lump-sum payments from the Company's pension plan to separated employees. These increases were partially offset by productivity improvements.

Selling, general and administrative

Selling, general and administrative costs remained relatively constant in all years. The slight increase in 1998 was driven primarily by sales growth and new initiative support costs. This increase was partially offset by lower advertising and marketing costs.

Depreciation and amortization

Depreciation and amortization decreased in 1997 from 1996 reflecting a reduction in depreciation rates to reflect higher salvage values for outside plant. The 1998 decrease primarily resulted from the discontinuation of depreciation expense for nonstrategic domestic access lines held for sale. In 1998, GTE announced its plan to sell approximately 1.6 million nonstrategic domestic access lines. Based on the decision to sell these access lines, the Company ceased recording depreciation expense. The decrease in both years was partially offset by the depreciation of capital additions, reflecting growth in the demand for access lines and data services.

Wireless Products and Services

Wireless Products and Services provides wireless communications services (both voice and data) within licensed areas in the U.S., sells cellular telephones and accessories and provides support services to other cellular telephone companies.

Revenues and Sales

	Years Ended December 31,		
	1998	1997	1996
		(Dollars in Millions)	
Service revenues	$ 2,687	$ 2,549	$ 2,347
Equipment sales and other	383	373	287
Total revenues	$ 3,070	$ 2,922	$ 2,634

The growth in service revenues was primarily attributable to the growth in GTE's wireless customer base of 7.4% in 1998 and 19.7% in 1997. Total U.S. customers served reached 4.8 million and 4.5 million in 1998 and 1997, respectively. In both 1998 and 1997, revenue growth resulting from the increased customer base was somewhat offset by a decline in revenues per customer per month, reflecting the increasing level of competition in the wireless industry. However, 1998 results reflect profitable growth by focusing on higher-value customers utilizing a value-based marketing strategy.

Operating Costs and Expenses

	Years Ended December 31,		
	1998	1997	1996
	(Dollars in Millions)		
Cost of services and sales	$ 1,049	$ 1,083	$ 908
Selling, general and administrative	848	974	846
Depreciation and amortization	435	428	398
Special charges	91	--	--
Total operating costs and expenses	$ 2,423	$ 2,485	$ 2,152

Cost of services and sales

Cost of services and sales decreased slightly in 1998 as compared with 1997 despite an increased customer base. The increased volumes were offset by reduced costs for cellular phones, favorable interconnection fees, lower fraud losses and increased productivity throughout the organization. Cost of services and sales also includes approximately $69 million of gains on the sale of assets in 1998. The 1997 increase over 1996 reflects higher equipment and operations costs due to a larger customer base, partially offset by lower roaming costs and lower fraud losses.

Selling, general and administrative

The 1998 decrease is attributable to lower customer acquisition and retention costs, including lower costs due to increased productivity in the retail channel. The 1997 increase reflects higher customer acquisition and retention costs, increased sales and marketing efforts to aggressively grow and retain the customer base and higher general and administrative costs to support a larger customer base.

Depreciation and amortization

Depreciation and amortization increased in both 1998 and 1997 as a result of continuing investment in the wireless network to provide greater capacity. The 1998 increase is partially offset by lower depreciation expense due to the discontinuation of the Tele-Go product offering and the write-off of affected network equipment and supplies, which is included in the special charges.

Data Products and Services

The Data Products and Services segment offers a wide range of advanced data and Internet-related services, including dedicated and dial-up access to the Internet, managed network security, Web-server hosting, application development and systems integration services. During 1998, GTE expanded its business service offerings to include E-Commerce Hosting, Virtual Private Networks, Global Remote Access and Digital Certificates. Data Products and Services also includes the investment in GTE's nationwide fiber-optic network. More than two thirds of the planned 17,000 miles of this network is operational. Additional investments in undersea cable expand the reach of the nationwide network into Europe, Asia and Latin America. During the latter half of 1998, the Company began migrating its customers' data and voice traffic to the network from leased facilities and began providing access and transport services to other ISPs and telecommunications carriers.

GTE's Data Products and Services segment was created in mid-1997 after the acquisition of BBN Corporation. This segment does not include the results of GTE's traditional local data businesses, such as T-1 connections and ISDN dedicated access, which continue to be reflected in the Company's Network Services segment.

Revenues and Sales

	Years Ended December 31,	
	1998	1997
	(Dollars in Millions)	
Data revenues	$ 784	$ 279
Intersegment revenues	(36)	(11)
Total external revenues	$ 748	$ 268

Revenues for 1998 reflect a full year of activity, whereas 1997 revenues reflect only a partial year, as described above. The increase in 1998 is also due to sales of access and transport services to other ISPs and carriers and the expanded relationship with America Online (AOL), for which GTE provides national network deployment services in support of AOL's dial-up network. The increase also reflects customer growth and revenues derived from newly introduced Internet-based products and services for both consumers and businesses.

Intersegment revenues reflect affiliate activity between Data Products and Services and other entities within National Operations.

Operating Costs and Expenses

	Years Ended December 31,	
	1998	1997
	(Dollars in Millions)	
Cost of services and sales	$ 754	$ 376
Selling, general and administrative	428	162
Depreciation and amortization	128	88
Total operating costs and expenses	$ 1,310	$ 626

Total operating costs and expenses for 1998 reflect a full year of activity, whereas 1997 reflects only a partial year, as described above.

Cost of services and sales

Cost of services and sales consists primarily of the cost of leasing telecommunication circuits and labor and expenses of operating the network infrastructure and supporting customers. The results reflect the growth in the cost of the network infrastructure and personnel to support a growing customer base and service offerings introduced during the year. Cost of services and sales also reflects the continued expansion of dial-up networks operated for AOL.

Selling, general and administrative

Selling, general and administrative costs are driven by customer growth, higher new product development costs and continued investment in the Company's sales and marketing infrastructure, including expansion of sales channels, advertising costs and other promotional activities related primarily to Internet-based services for consumers and businesses.

Depreciation and amortization

Depreciation and amortization reflects the continuing investment in the network and other infrastructure necessary to support the growth in customers and services. Capital expenditures during 1998 and 1997 collectively totaled over $900 million, primarily associated with the build-out of the 17,000 mile fiber-optic network.

Other National Operations

GTE's Other National Operations include: GTE Technology and Systems, GTE Communications Corporation, GTE Directories Corporation and GTE Airfone. Eliminations for intersegment activity occurring within National Operations are also included in Other National Operations.

Revenues and Sales

	Years Ended December 31,		
	1998	1997	1996
		(Dollars in Millions)	
Technology and Systems	$ 1,423	$ 1,271	$ 1,204
Communications	1,063	630	333
Other, including eliminations	651	746	875
Total revenues	$ 3,137	$ 2,647	$ 2,412

Operating Costs and Expenses

	Years Ended December 31,		
	1998	1997	1996
		(Dollars in Millions)	
Cost of services and sales	$ 2,347	$ 1,879	$ 1,442
Selling, general and administrative	635	561	369
Depreciation and amortization	196	250	260
Special charges	397	--	--
Total operating costs and expenses	$ 3,575	$ 2,690	$ 2,071

Technology and Systems is primarily composed of GTE Government Systems. As previously discussed, the Company has committed to a plan to sell its Government Systems unit. The Company expects to consummate the sale during 1999.

GTE Communications Corporation includes GTE's national sales and marketing organization, which enables GTE to expand its business beyond its traditional operating boundaries. GTE established this organization during 1997, to take advantage of the new opportunities available as a result of the changing regulatory environment. GTE Communications Corporation also includes GTE Long Distance, which provides long-distance services to customers in all 50 states, and GTE Video Services, which provides video services to residential and business customers primarily in California, Florida and Hawaii.

GTE Communications Corporation revenues grew $433 million, or 69%, during 1998. Revenues from long-distance operations grew $280 million, or 88%, during 1998, due to a 59% increase in the number of customers. Significant market share increases in GTE's franchised territories, coupled with a significant improvement in the rate of customer churn, contributed to this growth. Costs associated with the start up of the national sales and marketing organization and costs for the acquisition of long-distance customers contributed to increased operating losses compared with 1997.

Included in other revenues is GTE Directories Corporation, which publishes telephone directories and develops and markets online advertising and information services; and GTE Airfone, a provider of airborne communications services. In the first quarter of 1998, GTE announced its intention to dispose of GTE Airfone. Based on the decision to sell, the Company recorded a pretax charge of $200 million to reduce the carrying value of GTE Airfone's assets to estimated net sales proceeds. This amount is included in the special charges of $397 million. Also included is a pretax charge of approximately $161 million resulting from the Company's decision to scale back the deployment of hybrid fiber coax (HFC) video networks that it had built over the past three years in certain test markets. See the discussion of asset impairments on page 18 for further information. The remaining $36 million of the special charges relates to the decision to exit various business units involved in the development of interactive video products and services and to close excess printing facilities in the U.S.

International Operations

GTE's International Operations provide telecommunications services in Canada, the Dominican Republic and Argentina and operate directory advertising companies in Europe and Central America through consolidated subsidiaries. GTE also participates in ventures/consortia that are accounted for on the equity basis. These investments include a full-service telecommunications company in Venezuela, a paging network in China and a nationwide digital-cellular network in Taiwan. In the fourth quarter of 1998, GTE increased its ownership interest in CTI Holdings, S.A. (CTI) and changed its method of accounting for this investment from the equity basis to full consolidation. This change in accounting had no impact on net income. CTI provides cellular services in the north and south interior regions of Argentina.

Revenues and Sales

	Years Ended December 31,		
	1998	1997	1996
		(Dollars in Millions)	
Local services	$ 1,219	$ 1,076	$ 930
Toll services	907	883	932
Wireless services	422	265	215
Directory services and other	786	678	634
Total revenues	$ 3,334	$ 2,902	$ 2,711

Local services

Local service revenues are based on fees charged to customers for providing local telephone service within designated franchise areas. Local service revenues increased in 1998 due to a rate increase in Canada and an increase in access lines in service. Partially offsetting this revenue growth was a decrease of approximately $83 million in 1998 due to unfavorable exchange rates.

Toll services

Toll, or long-distance, service revenues are based on fees charged for calls made to a location outside of a customer's local calling area. Toll service revenues increased in 1998 primarily due to a change in the manner of reporting toll settlements by the Canadian operations. Early in 1998, Canadian carriers began reporting toll settlements on a gross revenue and expense basis. Previously, the carriers recorded toll settlements on a net basis (see offsetting increase in "Cost of services and sales" below). Toll revenues, excluding the modified settlement reporting, declined in 1998 and 1997 due to company-initiated rate reductions partially offset by higher toll volumes. GTE's International Operations continue to implement price reductions on certain domestic and international toll services in response to competition. Additionally, toll revenues reflect a decrease of approximately $50 million in 1998 due to unfavorable exchange rates.

Wireless services

Wireless services primarily represent cellular, PCS and paging services. The consolidation of CTI's operating revenues, in the fourth quarter of 1998, resulted in an increase in reported revenues of $121 million. Also contributing to wireless revenue growth in 1998 was an increase in wireless customers in Canada and the Dominican Republic, partially offset by a decrease of approximately $22 million due to unfavorable exchange rates.

Directory services and other

Directory services and other revenues result primarily from sales of Yellow Pages advertising to local and national businesses. The increase in 1998 directory services revenues was primarily driven by operations in Austria and Poland, that were acquired late in 1997, as well as higher directory advertising sales in the Costa Rican operation. Directory services revenues in 1997 increased as compared with 1996 due to higher directory advertising sales.

Operating Costs and Expenses

	Years Ended December 31,		
	1998	1997	1996
		(Dollars in Millions)	
Cost of services and sales	$ 1,147	$ 882	$ 842
Selling, general and administrative	856	771	715
Depreciation and amortization	459	523	463
Special charges	38	--	--
Total operating costs and expenses	$ 2,500	$ 2,176	$ 2,020

Cost of services and sales

The 1998 increase in cost of services and sales was primarily driven by higher operating costs associated with the change in the reporting of toll settlements in early 1998 (see offsetting increase in "Toll services" above), as well as higher customer acquisition costs related to an increase in wireless customers during the year. Additionally, cost of services and sales increased by $51 million as a result of the consolidation of CTI in the fourth quarter of 1998.

Selling, general and administrative

Selling, general and administrative expenses in both 1998 and 1997 increased primarily due to higher selling expenses related to the growth in customer additions. Approximately $30 million of the 1998 increase was a result of the consolidation of CTI in the fourth quarter of 1998.

Depreciation and amortization

Depreciation and amortization increased in 1997 as compared with 1996 due to the shortening of the depreciable lives of telephone plant, primarily in Canada. In 1998, the effect of shorter lives was offset by a reduction in the carrying value of plant due to the discontinuation of Statement of Financial Accounting Standards No. 71, "Accounting for the Effects of Certain Types of Regulation" (SFAS No. 71).

Special charges

The special charges relate to the write-off of impaired assets in Latin America, related primarily to the decision to exit nonstrategic business activities in the Dominican Republic ($33 million) and for employee severance and related actions ($5 million).

Equity Income

Equity income in 1998 increased $25 million from 1997 due to reduced losses for CTI for the first nine months of the year. As previously discussed, in the fourth quarter of 1998, GTE changed its method of accounting for this investment from the equity basis to full consolidation due to increased ownership of CTI.

Financial Condition

	Years Ended December 31,		
	1998	1997	1996
	(Dollars in Millions)		
Cash flows from (used in):			
Operations	$ 5,890	$ 6,164	$ 5,899
Investing	(5,508)	(5,893)	(4,277)
Financing	(466)	(125)	(1,549)

Operations

GTE's primary source of funds during 1998 was cash from operations of $5.9 billion compared with $6.2 billion in 1997. The decrease in cash from operations primarily reflects an increase in the Company's working capital requirements, including increased funding of GTE's postretirement liabilities in 1998 and costs associated with growing GTE's data initiatives and its national marketing and sales organization. The increase in 1997 from 1996 reflects the improved operating results from the National and International Operations.

Investing

Capital expenditures totaled $5.6 billion in 1998, a 9% increase from the $5.1 billion spent in 1997. The majority of the 1998 new investments were made to acquire facilities and develop and install applications necessary to support the growth in demand for GTE's core services, facilitate the introduction of new products and services, and increase operating efficiency and productivity. Significant investments are also being made to build and expand GTE's national fiber-optic data network. GTE expects capital expenditures to remain at approximately the same level in 1999. Cash used in investing activities was favorably impacted in 1998 due to the sales of certain nonstrategic wireless properties. In 1997, GTE expended over $900 million to acquire new operations, primarily BBN Corporation, in connection with the Company's data initiatives.

As previously announced, GTE has committed to a plan to sell GTE Government Systems, GTE Airfone and approximately 1.6 million domestic access lines over the next two years. These transactions are expected to generate after-tax proceeds in excess of $3 billion. Cash generated from these dispositions will be partially used to fund the Company's growth strategy. As announced in July 1998, GTE has also agreed to acquire approximately 40% of the Puerto Rico Telephone Company (PRTC) for approximately $350 million. This transaction closed in the first quarter of 1999.

Financing

In 1997-95, GTE announced plans to repurchase up to 20, 25 and 20 million shares, respectively, of its currently issued common stock from time to time, depending on market conditions. The shares will be used to satisfy the requirements of GTE's employee benefit and dividend reinvestment programs. Of the announced repurchase plans, a total of 38.8 million shares had been repurchased under the 1996 and 1995 programs. Cash used for the purchase of these shares was $1.7 billion through 1997. GTE did not repurchase any shares in 1998.

GTE targets a financial profile including capitalization and credit ratios that are appropriate for an "A" rated telecommunications corporation. This allows GTE's shareholders to enjoy the benefits of prudent and reasonable financial leverage, while also protecting debtholder interest and providing ready access to the capital markets. During July 1998, several rating agencies placed GTE, as well as certain GTE operating subsidiaries, on their "Watch" list for a potential debt rating increase as a result of the proposed merger with Bell Atlantic Corporation.

During 1998, GTE maintained its two syndicated credit facilities totaling $4.0 billion, including a five-year line of $2.5 billion for GTE and a 364-day line of $1.5 billion for certain domestic telephone operating subsidiaries. Under current terms and conditions, the $2.5 billion line will mature in June 2002 and the $1.5 billion line, which the Company expects to renew, will mature in June 1999. Fifty-four banks representing 12 countries participate in these syndicated facilities, which are used primarily to back up commercial paper borrowings. In August 1998, GTE negotiated bilateral credit agreements for an additional $1.0 billion in credit capacity. These facilities, which are shared by GTE and certain domestic telephone operating subsidiaries, are aligned with the maturity date of the existing 364-day line. The additional capacity provides greater flexibility to incur additional indebtedness of a shorter-term duration during periods when it may not be desirable to access the capital markets to refinance short-term debt. GTE and certain of its domestic telephone operating subsidiaries have shelf registration statements filed with the Securities and Exchange Commission that total $2.4 billion as of December 31, 1998.

In 1999, the funding of dividends and capital requirements for GTE's businesses will be substantially sourced by cash from operations, although GTE's strong financial position allows ready access to worldwide capital markets for any additional cash requirements.

Other Factors That May Affect Future Results

Regulatory and Competitive Trends

As was the case in 1997, much of 1998's regulatory and legislative activity at both the state and federal levels was a direct result of the Telecommunications Act. Along with promoting competition in all segments of the telecommunications industry, the Telecommunications Act was intended to preserve and advance universal service.

In 1998, GTE continued to meet the wholesale requirements of new competitors. GTE signed more than 750 interconnection agreements with other carriers, providing them the capability to purchase unbundled network elements (UNEs), resell retail services and interconnect facilities-based networks. Several of these interconnection agreements were the result of the arbitration process established by the Telecommunications Act, and incorporated prices or terms and conditions based upon the FCC rules that were subsequently overturned by the Eighth Circuit Court (Eighth Circuit) in July 1997. GTE challenged a number of such agreements in federal district courts during 1997.

The Company's position in these challenges was supported by the Eighth Circuit's July 1997 decision stating that the FCC had overstepped its authority in several areas concerning implementation of the interconnection provisions of the Telecommunications Act. In January 1999, the U.S. Supreme Court (Supreme Court) reversed in part and affirmed in part the Eighth Circuit's decisions. The Supreme Court reversed the Eighth Circuit on many of the FCC rules related to pricing and costing, that had previously been reversed by the Eighth Circuit on jurisdictional grounds. The pricing rules established by the FCC will now be remanded back to the Eighth Circuit for a determination on the merits. On the other hand, the Supreme Court vacated the FCC rules requiring incumbent local exchange carriers (LECs) to provide unbundled network elements to competitive LECs. This latter ruling will be the subject of continued proceedings before the FCC and the state commissions concerning what elements will have to be offered under what conditions. Pending the final rulemaking by the FCC on the provisions of unbundled network elements, GTE will continue to provide individual unbundled network elements under existing interconnection agreements.

Concurrent with competitors' entry into GTE markets, the Company has continued its own expansion into local, long-distance, Internet-access, wireless and video services both within and outside its traditional operating areas. GTE now provides long-distance and dial-up Internet-access services to approximately 2.7 million and 500,000 customers, respectively.

Interstate Access Revision

Access charge reform continued to be a major issue in 1998. Effective January 1998, the FCC altered the structure of access charges that the Company collects by reducing and restructuring the per-minute charges paid by long-distance carriers and implementing new per-line charges. The FCC also created an access charge structure that resulted in different access charges for primary and secondary residential access lines and single and multi-line business access lines. In aggregate, the annual reductions in usage-sensitive access charges paid by long-distance carriers were intended to be offset by new per-line charges and additional charges paid by end-user customers. Effective July 1998, access charges were further reduced in compliance with FCC requirements to reflect the impacts of access charge reform and in making the Company's 1998 Annual Filing. Similar filings during 1997 had already resulted in price reductions.

The FCC Access Reform Order released in May 1997 revamped the rate structure through which local and long-distance companies charge customers for using the local phone network to make long-distance calls. GTE and numerous other parties challenged the FCC's May 1997 Access Reform Order before the Eighth Circuit based on the premise that the FCC did not eliminate the universal service subsidies hidden within interstate access charges (as directed by the Telecommunications Act), and the FCC created additional subsidy charges paid only by business and multi-line residential customers. In August 1998, the Eighth Circuit denied all of the petitions for review of the Access Reform Order. In October 1998, the FCC began a proceeding to refresh the record used in the 1997 access charge reform proceedings. The FCC will determine whether to retain or modify its market-based access charge reform approach, or to adopt a prescriptive approach. In addition, the FCC will decide whether the 6.5% productivity offset should be changed. An order is expected to be released prior to July 1999.

Universal Service

In May 1997, the FCC released a decision relating to implementation of the Telecommunications Act's provisions on universal service. GTE and numerous other parties have challenged the FCC's decision before the U.S. Court of Appeals for the Fifth Circuit on the grounds that the FCC did not follow the requirements of the Telecommunications Act to develop a sufficient, explicit and competitively neutral universal service program. Oral arguments were held in December 1998. A final decision on the appeal is expected in 1999.

In its Order on Reconsideration of the May 1997 decision dated July 1998, the FCC referred some key issues back to the Federal-State Joint Board (Joint Board) on universal service. The Joint Board issued its Second Recommended Decision in November 1998. The recommendations were generic in nature and require further development. Comments and reply comments on the Joint Board's recommendations were filed in late December 1998 and January 1999, respectively. An order from the FCC is expected in the second quarter of 1999, which may reject or change the Joint Board's recommendations.

In October 1998, the FCC issued an order selecting a cost model for universal service and plans to select cost inputs by the first quarter of 1999 and a revenue benchmark by mid-1999. For this reason, the FCC moved the implementation date of the new universal service mechanism for nonrural carriers to July 1999. The Company filed a Petition for Reconsideration in December 1998, stating that the adopted model is incomplete and requires additional time for proper evaluation. GTE is currently awaiting action from the FCC.

Price Cap

For the provision of interstate services, the Company operates under the terms of the FCC's price cap incentive plan. This plan limits the rates a carrier may charge rather than regulating on a traditional rate-of-return basis. The price caps for a variety of service categories change annually using a price cap index that is a function of inflation less a predetermined productivity offset. The FCC's May 1997 Price Cap Order revised the price cap plan for incumbent price cap LECs by adopting a productivity offset of 6.5%. In June of 1997, GTE and several other parties challenged the FCC's Price Cap Order before the Court of Appeals for the District of Columbia Circuit. The issue presented for review was whether, in computing its new 6.5% productivity offset, the FCC arbitrarily manipulated the evidence to achieve a predetermined outcome. Oral arguments are set for the first quarter of 1999 with a decision expected later in the year.

Advanced Data Service

In August 1998, the FCC released a Memorandum Opinion and Order finding that the pro-competitive provisions of the Telecommunications Act apply equally to advanced services and circuit-switched voice services. In comments filed in September 1998, GTE outlined a comprehensive plan to rapidly deploy advanced data services, such as asymmetric digital subscriber line (ADSL) service, in a framework that permits real competition between incumbents and competitors. The matter is pending before the FCC. In October 1998, the FCC found in favor of GTE's position that ADSL service is interstate in nature and properly tariffed at the federal level. The FCC specifically concluded that traffic to an ISP does not terminate at the ISP's local server but continues on to the ultimate destination or destinations at distant interstate or international websites accessed by the end-user.

Number Portability

In December 1998, the FCC released a Memorandum Opinion and Order regarding cost recovery for the deployment of local number portability (LNP). This order follows the FCC's Third Report and Order, which determined that carriers may recover carrier-specific costs directly related to the provision of long-term LNP via a federally tariffed end-user monthly charge beginning no earlier than February 1999. GTE filed a LNP tariff and instituted an end-user number portability fee per line, which began appearing on customer bills in March 1999. The FCC is investigating the costs supporting the filing.

Internet Service Traffic

On February 25, 1999 the FCC adopted an order finding that dial-up ISP-bound traffic is largely interstate based on a traditional examination of the end-to-end nature of the communication. In this ruling the FCC made it clear that its actions will not subject the Internet to regulation or eliminate the current Enhanced Service Provider exemption. The order stated that in the absence of a federal rule, existing state arbitration decisions on the issue may be appropriate under certain conditions. GTE is currently reviewing its existing contracts and commission orders and will take further action as necessary. The order also contained a Notice of Proposed Rulemaking to consider the appropriate compensation for this traffic in the future. GTE has appealed the FCC's conclusion that it does not have to set a rate after it finds the traffic to be jurisdictionally interstate.

International

The global communications industry is in the midst of a major transformation away from serving the regulatory-driven needs of the telecommunications market. This new marketplace will be characterized by demand for both expanded basic communication services in developing markets and a wide range of new services for the delivery of data, voice, multimedia, and information services to a variety of different customers. In addition, the FCC's new foreign participation rules, adopted to implement the United States' World Trade Organization commitments, significantly liberalized the policies for international telecommunications and satellite services. Since adopting the new rules in November 1997, the FCC has granted over 700 applications to foreign and domestic applicants to provide international service in the United States.

Throughout Latin America, telecommunications providers will be faced with a series of challenges, new opportunities, and deregulation in 1999. In Venezuela, a new president was recently elected seeking a fundamental restructuring of the Venezuelan state, including the National Assembly. In addition, recent actions by CONATEL (Venezuela's telecommunications regulatory body) included approval of draft Interconnection Regulations, the implementation of expanded local calling areas, and the development of a new telephone numbering plan. Deliberations between CANTV (an affiliate of GTE) and CONATEL on the opening of competitive telecommunications in Venezuela will begin in 1999.

In Argentina, hearings have begun to discuss the new licensing plans and regulatory framework, which will promote a more competitive Argentine telecommunications market. The decisions resulting from these hearings will influence the rules of the marketplace in which GTE's cellular subsidiary, CTI, and three other full-service providers will compete by November 1999. In the Dominican Republic, a new Telecommunications Law was enacted, which, when implemented, will help eliminate subsidies from local service and create a new regulatory body composed of members from both the public and private sectors. CODETEL, a wholly-owned subsidiary of GTE, operates in the Dominican Republic.

GTE's position is growing in Asia, where the Company provides PCS service in Taiwan and paging service in China. From this base in Asia, GTE will continue to share in the region's growth.

In Canada, GTE already provides a wide range of telecommunications services through its BC TELECOM Inc. (BC TELECOM) and Québec Telephone (Québec Tel) operations. On January 31, 1999, BC TELECOM, a majority-owned investment of GTE, and TELUS Corporation (TELUS) merged in order to better leverage the synergies between the two companies, as well as take advantage of the opening of competition throughout the Canadian telecommunications market. (See "1999 Developments" for further information on this merger.) Québec Tel will also be subject to the continued pro-competitive changes in regulation.

As can be seen in these activities around the globe, GTE continues its development of new telecommunications business opportunities throughout the world in order to secure a strategic position for the dynamic future ahead.

Proposed Merger with Bell Atlantic Corporation

On July 27, 1998, GTE and Bell Atlantic entered into a merger agreement providing for a combination of the two companies. Under terms of the agreement, which was unanimously approved by the boards of directors of both companies, GTE shareholders will receive 1.22 shares of Bell Atlantic stock for each GTE share they own. The merger is subject to shareholder and regulatory approvals. The merger agreement requires the consent of several regulatory and governmental agencies, including the Department of Justice (DOJ), FCC and various state public utility commissions (PUCs). In August 1998, GTE and Bell Atlantic advised the DOJ of the merger. On October 2, 1998, GTE and Bell Atlantic filed for approval of the merger with the FCC and notified and/or filed for approval of the parent company merger in every state PUC and the District of Columbia where required. The DOJ and FCC reviews will continue into 1999. As of December 31, 1998, GTE had completed, or substantially completed, merger approvals in 34 states. The Company anticipates the remaining states will approve the merger sometime in 1999.

1999 Developments

On January 31, 1999, BC TELECOM, a majority-owned investment of GTE, merged with TELUS to create a growth-oriented telecommunications company. The merged company is called BCT.TELUS Communications, Inc. Initially, BCT.TELUS will provide a full range of voice and data communications services over both wireline and wireless networks in the Canadian provinces of British Columbia and Alberta. Under the terms of the merger agreement, GTE's ownership interest in the merged company is approximately 26.7%. Accordingly, during the first quarter of 1999, GTE will deconsolidate BC TELECOM and account for its investment in BCT.TELUS using the equity method of accounting. As a result, GTE expects to record a one-time, noncash gain of approximately $300 million after-tax in the first quarter of 1999.

In Puerto Rico, GTE agreed to purchase a 40% interest in PRTC from the government of Puerto Rico. PRTC is currently the largest provider of local telephone service across Puerto Rico and also competes with several other companies in long-distance and cellular services. This acquisition, which closed in the first quarter of 1999, will play a key role in GTE's Latin American strategy.

During the first quarter of 1999, GTE also continued the review of its operations and cost structure to ensure they were consistent with its growth objectives. In connection with this ongoing review, GTE expects that additional one-time charges of approximately \$150-\$225 million after-tax will be recorded during the first quarter of 1999. This charge is expected to include approximately \$100-\$150 million after-tax related to the separation of 2,500-3,500 employees and associated facilities costs. The components of the charge will include separation and related benefits such as outplacement and benefit continuation costs and the cost of assets or facilities that will no longer be used by the Company.

Year 2000 Conversion

General

The Year 2000 issue concerns the potential inability of information systems to properly recognize and process date-sensitive information beyond January 1, 2000, and has industry-wide implications. GTE has had an active Year 2000 program in place since 1995. This program is necessary because the Year 2000 issue could impact telecommunications networks, systems and business processes at GTE. Although GTE maintains a significant portion of its own systems and infrastructure, the Company also depends on certain, material external supplier products that GTE must verify as Year 2000 compliant in their condition of use. In 1997, GTE's Year 2000 methodology and processes were certified by the Information Technology Industry Association of America. GTE presently expects that the essential functions of its telecommunications businesses will complete Year 2000 testing by June 30, 1999.

State of Readiness

GTE's Year 2000 program is focused on both information technology (IT) and non-IT systems, including: 1) telecommunications network elements that constitute the portion of the public switched telephone network (PSTN) for which GTE is responsible; 2) systems that directly support GTE's telecommunications network operations and interactions with customers; 3) systems and products that support GTE's national and international business units; 4) legacy software that supports basic business operations, customer premise equipment and interconnection with other telecommunications carriers; and 5) systems that support GTE's physical infrastructure, financial operations and facilities.

Company-wide, essential remediation was approximately 76% complete as of December 31, 1998. In addition to the essential remediation budget, GTE has set aside funds equivalent to approximately 12% of the Company's overall Year 2000 budget. These funds are planned for verification, problem resolution and administrative program closeout in the last six months of 1999 and to address contingencies and millennium program operations and control through March 2000. GTE's portion of the PSTN in the United States has been upgraded substantially for Year 2000; 92% of GTE's access lines are already operational using Year 2000 compliant central office switches. Additionally, over 95% of the Company's essential legacy software has been remediated. Over the next six months, the focus will be on deployment and testing of these systems throughout GTE's operations.

GTE's Year 2000 program has been organized into five phases as follows: Awareness: program definition and general education; Assessment: analysis and prioritization of systems supporting the core business; Renovation: rectifying Year 2000 issues; Validation: testing the Year 2000 solutions; Implementation: placing the tested systems into production. Awareness and Assessment are more than 95% complete; System Renovation, including supplier products, is approximately 89% complete; Validation, including enterprise testing in operational environments, and Implementation, including regional deployment, are approximately 60% complete. It is anticipated that the Renovation, Validation and Implementation phases for essential functions will be complete in June 1999.

In summary, compliant product deployment and enterprise testing for most of GTE's domestic telecommunications-related businesses, including national and international interoperability and validation, are presently expected to be complete by the end of June 1999. BBN Corporation, a provider of Internet-based services acquired by GTE in 1997, is presently targeting completion of its key infrastructure systems by the end of September 1999. As previously mentioned (see "Financial Condition – Investing"), in July 1998, GTE agreed to acquire approximately 40% of PRTC. This transaction closed in the first quarter of 1999. The cost of GTE's Year 2000 program includes the cost for the PRTC Year 2000 program, which is expected to be complete by the end of the third quarter of 1999. Condition – Investing

Successful conclusion of GTE's Year 2000 program depends upon timely delivery of Year 2000 compliant products and services from external suppliers. Approximately 1,450 of third-party products used by GTE have been determined to be "vital" products, critical to GTE's business and operations. As of December 31, 1998, Year 2000 compliant versions, or suitable alternatives, for 99% of these vital supplier products have been provided and are currently undergoing certification testing by GTE.

Use of Independent Verification and Validation

GTE's Year 2000 program management office has established a company-wide quality oversight and control function that reviews and evaluates quality reports on the Year 2000 issue. Each GTE business unit has access to an independent quality team that evaluates the conversion and testing of legacy applications and third-party supplier products. This quality assurance process is expected to be completed in August 1999. Separately, GTE's corporate internal auditors conduct periodic reviews and report significant findings, if any, to business unit and corporate management and the audit committee of the Board of Directors. Program status is also reported each quarter to the Company's external auditors.

Cost to Address Year 2000 Issues

The current estimate for the cost of GTE's Year 2000 Program is approximately $370 million. Through December 31, 1998, expenditures totaled $219 million. Year 2000 remediation costs are expensed in the year incurred. GTE has not elected to replace or accelerate the planned replacement of systems due to the Year 2000 issue.

Currently supporting GTE's Year 2000 program worldwide are an estimated 1,000 to 1,200 full-time equivalent workers (both company employees and contractors). Approximately 12% of these full-time equivalent workers are engaged in all aspects of program management; 30% are engaged in legacy system conversion; 25% are involved in external supplier management; 30% are involved in testing at all levels; and 3% are addressing contingency planning and interoperability operations both nationally and internationally. Approximately 75% of GTE's program effort involves U.S. domestic operations of all types.

Risks of Year 2000 Issues

GTE has begun to examine the risks associated with its "most reasonably likely worst case Year 2000 scenarios." To date, GTE has no indication that any specific function or system is so deficient in technical progress as to threaten GTE's present schedule. GTE's program and plans currently indicate a compliant network infrastructure to be deployed by the end of June 1999. A general, unspecific, schedule shift that would erode progress beyond January 1, 2000, cannot reasonably be calculated. If, however, there were a schedule delay lasting no more than six months, such schedule erosion would likely affect only nonessential systems due to the prioritization of work schedules.

Other scenarios might include a possible but presently unforeseen failure of key supplier or customer business processes or systems. This situation could conceivably persist for some months after the millennium transition and could lead to possible revenue losses. GTE's present assessment of its key suppliers and customers does not indicate that this scenario is likely.

To date, GTE has not encountered any conditions requiring tactical contingency planning to its existing Year 2000 program; however, contingency planning for business and network operations and customer contact during 1999 and 2000 is ongoing.

GTE is bolstering its normal business continuity planning to address potential Year 2000 interruptions. In addition, GTE's disaster preparedness recovery teams are including procedures and activities for a "multi-regional" Year 2000 contingency, if it occurs. GTE is also developing its plans with respect to possible occurrences immediately before, during, and after the millennium transition. Under consideration are: "follow-the-sun" time-zone impact analysis; coordination with other (non-PSTN) telecommunications providers; a Year 2000 "war room" operation to provide high-priority recovery support, plans for key personnel availability, command structures and contingency traffic routing; and plans for round-the-clock, on-call repair teams.

Recent Accounting Pronouncements

In March 1998, the American Institute of Certified Public Accountants issued Statement of Position (SOP) 98-1, "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use." Under the provisions of this SOP, effective January 1, 1999, GTE will be required to capitalize and amortize the cost of all internal-use software, including network-related software it now expenses. During 1998, the Company expensed network-related software of approximately $200 million.

In June 1998, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 133, "Accounting for Derivative Instruments and Hedging Activities," which establishes accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts, and for hedging activities. The statement requires entities that use derivative instruments to measure these instruments at fair value and record them as assets or liabilities on the balance sheet. It also requires entities to reflect the gains or losses associated with changes in the fair value of these derivatives, either in earnings or as a separate component of comprehensive income, depending on the nature of the underlying contract or transaction. The Company is currently assessing the impact of adopting SFAS No. 133, which is effective January 1, 2000.

Forward-Looking Statements

GTE estimates that consolidated earnings per share will grow 13% to 15% in 1999 and beyond. Contributing to this growth is the expected turnaround in start-up costs associated with GTE's data initiatives and bundled telecom offerings through our national sales and marketing organization. In addition, this growth reflects cost-cutting initiatives, including programs to reduce expenses and decrease the number of contractors and employees, primarily through attrition and other voluntary efforts, in the U.S. The Company expects a one-time charge in the first quarter of 1999 to recognize these cost-cutting initiatives. GTE also expects to record a noncash gain of approximately $300 million in the first quarter of 1999 resulting from the merger of BC TELECOM and TELUS. Consolidated revenues are expected to grow in the high single digits through 1999, rather than the 10% to 12% previously estimated. This reduction is due to the Company's plan to moderate the expansion of its national sales and marketing operation, and increase focus on the roll-out of the Company's long-distance activities within bundled telecom offerings.

Cautionary Statement Regarding Forward-Looking Statements

In this Management's Discussion and Analysis of Financial Condition and Results of Operations, the Company has made forward-looking statements. These statements are based on the Company's estimates and assumptions and are subject to certain risks and uncertainties. Forward-looking statements include the information concerning possible or assumed future results of operations of the Company, as well as those statements preceded or followed by the words "anticipates," "believes," "estimates," "expects," "hopes," "targets" or similar expressions. For each of these statements, the Company claims the protection of the safe harbor for forward-looking statements contained in the Private Securities Litigation Reform Act of 1995.

The future results of the Company could be affected by subsequent events and could differ materially from those expressed in the forward-looking statements. If future events and actual performance differ from the Company's assumptions, the actual results could vary significantly from the performance projected in the forward-looking statements.

The following important factors could affect the future results of the Company and could cause those results to differ materially from those expressed in the forward-looking statements: 1) materially adverse changes in economic conditions in the markets served by the Company or by companies in which GTE has substantial investments; 2) material changes in available technology; 3) the final resolution of federal, state and local regulatory initiatives and proceedings, including arbitration proceedings, and judicial review of those initiatives and proceedings, pertaining to, among other matters, the terms of interconnection, access charges, universal service, unbundled network elements and resale rates; 4) the extent, timing, success and overall effects of competition from others in the local telephone and intraLATA toll service markets; and 5) the success and expense of our remediation efforts and those of our suppliers, customers, joint ventures, noncontrolled investments and all interconnecting carriers in achieving Year 2000 compliance. In addition, GTE has embarked on a major initiative to expand its service capability in the data communication, long-distance and enhanced services segments of the telecommunications marketplace and to provide a bundle of products and services both in and outside of its traditional service territories. Whether the Company realizes the benefits of these initiatives depends on GTE's ability to successfully develop the network facilities and systems required to provide these enhanced services, the success of its marketing initiatives, the levels of demand that are created for these services and the level of competition the Company faces as it seeks to penetrate new markets and emerging markets for new products and services. While GTE's management believes that it will be successful in implementing these new initiatives, there are uncertainties associated with its ability to increase revenue and income growth rates to the levels targeted through these initiatives and its ability to do so within the planned timeframes or investment levels.

Item 7A. Quantitative and Qualitative Disclosures About Market Risk

GTE views derivative financial instruments as risk management tools and, in accordance with Company policy, does not utilize them for speculative or trading purposes. GTE is also not a party to any leveraged derivatives. GTE is exposed to market risk from changes in interest rates and foreign currency exchange rates, as well as changes in the market price of GTE's common stock. GTE manages its exposure to market risks through its regular operating and financing activities and, when deemed appropriate, through the use of derivative financial instruments that have been authorized pursuant to the Company's policies and procedures. The use of these derivatives allows GTE to reduce its overall exposure to market risk, as the gains and losses on these contracts substantially offset the gains and losses on the liabilities being hedged. In addition, GTE enters into derivative financial instruments with a diversified group of major financial institutions in order to manage its exposure to nonperformance on such instruments.

GTE uses derivative financial instruments to manage its exposure to interest rate movements and to reduce borrowing costs. GTE's net exposure to interest rate risk primarily consists of floating rate instruments that are benchmarked to U.S. and European short-term money market interest rates. GTE manages this risk by using interest rate swaps to convert floating rate long-term and short-term debt to synthetic fixed rate instruments. GTE also uses forward interest rate swaps and forward contracts to sell U.S. Treasury bonds to hedge interest rates on anticipated long-term debt issuances.

Based on GTE's interest rate sensitive derivative financial instruments outstanding at December 31, 1998, a 100 basis point increase in interest rates as of December 31, 1998, would result in a net gain to GTE of $31 million. Conversely, a 100 basis point decrease in interest rates would result in a net loss to GTE of $32 million. Any increase or decrease in the market value of GTE's interest rate sensitive derivative financial instruments would be substantially offset by a corresponding decrease or increase in the market value of the underlying liability or anticipated debt issuance.

GTE uses foreign currency derivative instruments to reduce its exposure to adverse changes in foreign currency rates. The use of these derivatives allows GTE to reduce its overall exposure to exchange rate fluctuations, as the gains and losses on these contracts substantially offset the gains and losses on assets and liabilities being hedged. The Company's exposure to foreign exchange rates primarily exists with respect to loans denominated in British pounds and short-term investments denominated in Canadian dollars. As of December 31, 1998, GTE's exposure resulting from fluctuations in foreign currency exchange rates was not material.

In the past, GTE issued stock options to certain of its employees that had tandem stock appreciation rights. To minimize GTE's exposure to compensation expense related to these stock appreciation rights, GTE purchased long-term call options on its common stock. As a result of these purchases, a $5 change in the per-share price of GTE's common stock would impact GTE's pretax earnings by approximately $35 million, as of December 31, 1998. However, gains and losses recognized on the call options would be substantially offset by increased or decreased compensation expense related to stock appreciation rights.